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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

NORTHSTAR FINANCIAL
ADVISORS, INC., on Behalf of Itself
and all Others Similarly Situated,

Plaintiff,

v.

SCHWAB INVESTMENTS;
and MARIANN BYERWALTER,
DONALD F. DORWARD, WILLIAM
A. HASLER, ROBERT G. HOLMES,
GERALD B. SMITH, DONALD R.
STEPHENS, MICHAEL W. WILSEY,
CHARLES R. SCHWAB, RANDALL
W. MERK, JOSEPH H. WENDER and
JOHN F. COGAN as TRUSTEES OF
SCHWAB INVESTMENTS; and
CHARLES SCHWAB INVESTMENT
MANAGEMENT, INC.

Defendants.

Case No. 08-cv-04119 LHK

CLASS ACTION

**SECOND AMENDED CLASS ACTION
COMPLAINT**

JURY TRIAL DEMANDED

Plaintiff, for its Second Amended Class Action Complaint, alleges the following upon personal knowledge as to itself and its own acts, and upon information and belief as to all other matters, based upon the investigation made by its attorneys, which included a review of

1 Securities and Exchange Commission (“SEC”) filings, news reports and other publicly
2 available materials.

3 NATURE OF THE ACTION

4 1. This action is brought by Northstar Financial Advisors, Inc., individually, and
5 on behalf of persons who owned shares of the Schwab Total Bond Market Fund (the “Fund” or
6 “Index Fund”) (Ticker: SWLBX) at any time from August 31, 2007 through February 27, 2009,
7 and were damaged thereby.

8 2. This action is brought against Schwab Investments, the members of the Board of
9 Trustees of Schwab Investments, and Charles Schwab Management, Inc. for violating
10 shareholders’ rights and causing the Fund to deviate from its fundamental investment objective
11 to “seek to track the investment results” of the Lehman Brothers U.S. Aggregate Bond Index
12 (the “Index”) (Ticker: LBUSTRUU) “through the use of an indexing strategy.”

13 3. The Fund deviated from its stated investment objective by investing a material
14 percentage of its portfolio in high risk non-U.S. agency collateralized mortgage obligations
15 (“CMOs”). The non-U.S. agency CMOs were not part of the Lehman Index and were
16 substantially more risky than the U.S. agency securities and other instruments that comprised
17 the Index.

18 4. The Fund also deviated from its stated fundamental investment objective by
19 investing more than 25% of its total assets in U.S. agency and non-agency mortgage-backed
20 securities and CMOs. The Fund’s investment objectives prohibited any concentration of
21 investments of “25% or more of the value of the total assets in any industry” (other than if
22 necessary to track the Index).

23 5. Defendants’ deviation from the Fund’s investment objective exposed the Fund
24 and its shareholders to tens of millions of dollars in losses stemming from a sustained decline in
25 the value of non-agency mortgage-backed securities. The Fund’s deviation from its stated
26 investment objective caused investors to suffer a negative 12.64% differential in total return for
27 the Fund compared to the Index for the period August 31, 2007 through February 27, 2009,
28

1 consisting of a negative total return of 4.80% for the Fund compared to a positive total return of
2 7.85% for the Index over that same period (including interest payments).

3 **JURISDICTION AND VENUE**

4 6. This Court has jurisdiction over the subject matter of this action under 28 U.S.C.
5 §§1332(d)(2) and 1367. The plaintiff is diverse from at least one of the defendants and the
6 amount in controversy exceeds \$5 million.

7 7. Venue is properly laid in this District under 28 U.S.C. § 1391(b). Many of the
8 acts giving rise to the violations of law complained of herein, including the dissemination to
9 shareholders of the Registration Statements, Proxy Statements, and Prospectuses referenced
10 herein occurred in this District.

11 **PARTIES**

12 8. Plaintiff Northstar Financial Advisors, Inc. (“Northstar”) is a New Jersey
13 corporation with offices at 46 Beachmont Terrace, North Caldwell, NJ 07006.

14 9. Northstar is a registered investment advisory and financial planning firm serving
15 both institutional and individual clients. Northstar manages both discretionary and non-
16 discretionary accounts on behalf of investors in its role as an investment advisor.

17 10. With respect to its discretionary accounts, which form approximately 50% of its
18 assets under management, Northstar retains discretion over investment decisions.

19 11. Northstar had at all relevant times herein purchased and sold securities on behalf
20 of its clients as an independent investment advisor through Charles Schwab’s Institutional
21 Advisor Platform.

22 12. Northstar, in purchasing and/or selling shares in the Fund, relied on defendants’
23 contractual and fiduciary obligations with respect to the Fund’s investment objectives and
24 policies.

25 13. On or about August 31, 2007, Northstar had 239,290 shares of the Fund under
26 its management.

27 14. Northstar operates under a fee-based structure based on the total value of assets
28 under management. Northstar is customarily paid on a quarterly basis a .5% to 1.0%

1 annualized management fee based on the valuation of assets under management, including the
2 reported net asset value (“NAV”) of the shares of the Fund under Northstar’s management.
3 Northstar suffered actual financial injury from the diminution of its management fee as a result
4 of the underperformance of the Fund against the Index subsequent to August 31, 2007.

5 15. By way of Assignment of Claim, dated December 8, 2008 (the “Assignment”),
6 Henry Holz, a client of Northstar who owned 4,181.093 shares of the Fund as of August 31,
7 2007, assigned to Northstar “all of the Assignor’s right, title and interest in any claim that the
8 Assignor has or could have against Schwab Investments, Charles Schwab & Co., Inc., Charles
9 Schwab Investment Management, Inc. and Schwab Total Bond Market Fund” The
10 Assignment of Claim was amended on September 28, 2010 to include claims asserted against
11 the Trustees of Schwab Investments.

12 16. Defendant Schwab Investments, at all relevant times since at least 1997, has had
13 its headquarters at 101 Montgomery Street, San Francisco, CA 94104. Schwab Investments is
14 an investment trust (the “Trust” or “Schwab Trust”), organized under Massachusetts law and is
15 a registered investment company under the Investment Company Act of 1940 (the “ICA” or
16 “Investment Company Act”). The Trust consists of a series of mutual funds, including the
17 Fund.

18 17. The Schwab Trust is an affiliate of and subject to the control of The Charles
19 Schwab Corporation (the “Schwab Corp.”), and defendant Charles Schwab, individually
20 (“defendant Schwab”).

21 18. The Schwab Trust is a legal fiction in that it owns no assets and has no
22 employees. Rather, the Schwab Trust contracts out all its management and operation functions
23 to other “Schwab” companies affiliated with the Schwab Corp.

24 19. The Schwab Trust is managed by a Board of Trustees. The Trust and its Board
25 of Trustees are responsible for filing with the SEC and disseminating to investors documents
26 regarding the Fund. The Schwab Trust and its Board of Trustees are also responsible for
27 supervising the Fund’s investment advisor and monitoring the Fund’s compliance with its
28 stated investment objectives and policies. According to the Statements of Additional

Information made available to investors in the Index Fund, the Trustees of the Trust “are responsible for protecting shareholder interests.”

20. Defendants Mariann Byerwalter, Donald F. Dorward, William A. Hasler, Robert G. Holmes, Gerald B. Smith, Donald R. Stephens, Michael W. Wilsey, Charles R. Schwab, and Randall W. Merck, were, according to the Fund’s Prospectus dated November 15, 2007, the Trustees of the Fund as of August 31, 2007. The following chart identifies each Trustee as of August 31, 2007, the Trustee’s length of service, the number of discrete portfolios in the Schwab fund complex that the Trustee oversaw (with the Fund being one such portfolio), and the Trustee’s annual compensation derived as a Trustee of Schwab taxable and tax-free mutual funds:

<u>Name of Trustee</u>	<u>Years of Service</u>	<u>Portfolios Overseen</u>	<u>Annual Compensation</u>
Byerwalter, Mariann	Since 2000	70	\$230,642
Dorward, Donald F.	Since 1989	59	\$202,775
Hasler, William A.	Since 2000	70	\$230,642
Holmes, Robert G.	Since 1989	59	\$202,775
Smith, Gerald B.	Since 2000	59	\$202,775
Stephens, Donald R.	Since 1989	59	\$202,775
Wilsey, Michael W.	Since 1989	59	\$202,775
Schwab, Charles R.	Since 1989	59	N/A
Merck, Randall W.	Since 2005	70	N/A

21. According to the Amended Prospectus dated June 13, 2008, defendants Joseph H. Wender and John F. Cogan joined the Board of Trustees in 2008, replacing defendants Holmes and Dorward as Trustees. The Trustee defendants are referred to herein in the aggregate as the Trustees.

22. The Fund’s shareholders and shareholders of other Schwab mutual funds are not required to vote annually or periodically on appointment of Trustees. Rather, those Trustees

1 may be selected by, or selected with the acquiescence of, defendant Schwab and the Schwab
2 Corp. as controlling persons of the Trust.

3 23. Each Trustee serves with respect to all or substantially all the Schwab mutual
4 funds, and the Investment Advisor is the investment manager for all the Schwab mutual funds.

5 24. Although the Schwab Trust and the Schwab Trustees were responsible for
6 reviewing the performance and fees of the Investment Advisor (as defined below) on an annual
7 basis, in fact, no Schwab Trust or trustee has ever selected a non-Schwab entity as a Schwab
8 fund's investment manager. Rather, the Trust and Trustees merely serve to rubber-stamp the
9 determinations made by the Schwab Corp. and defendant Schwab.

10 25. Because Trustee-defendants Schwab and Merk are interested trustees employed
11 by the Schwab Corp., their compensation is not paid by the Schwab Trust, but rather by the
12 parent corporation or other affiliates of the Schwab Corp. Defendant Charles Schwab was paid
13 cash compensation for 2007 of \$6.6 million for his services as Chairman and CEO of the
14 Schwab Corp.

15 26. Defendant Schwab founded the Schwab Corp. in 1971, and has served as its
16 Chairman since 1978. Defendant Schwab has also served as Schwab Corp.'s CEO at various
17 times, including from 2004 through October 2008.

18 27. According to the Schwab Corp.'s Proxy Statement dated May 13, 2010,
19 defendant Schwab owns approximately 200 million shares, or approximately 17.0% of the
20 outstanding common stock of the Schwab Corp. That Proxy Statement recites that defendant
21 Schwab's "vision continues to drive the company's growth."

22 28. Defendant Schwab is also identified in the Proxy Statement as Chairman and
23 trustee of The Charles Schwab Family of Funds and Schwab Investments, among other Schwab
24 related entities.

25 29. Defendant Schwab, by virtue of his stock ownership in the Schwab Corp. and
26 his positions as Chairman and trustee of the Schwab Corp. and affiliated entities, is considered
27 a controlling person of the Schwab Corp. and its affiliated entities.
28

1 30. Defendant Charles Schwab Investment Management, Inc. (the “Schwab
2 Advisor”), at all relevant times since at least 1997), has had its headquarters at
3 101 Montgomery Street, San Francisco, CA 94104. The Schwab Advisor is the investment
4 advisor to the Fund. The Schwab Advisor receives a management fee from the Fund. The
5 Schwab Advisor’s management fee is 0.25% of the Fund’s net assets, or approximately \$3.5
6 million per year. In addition, the Index Fund incurs 0.28% of net assets in other expenses, for a
7 total annual operating expense of 0.53%. The Schwab Advisor is responsible for preserving
8 shareholders’ voting rights and adhering to the Fund’s stated investment objectives and
9 policies. The Investment Advisor is organized under Delaware law. The Investment Advisor is
10 wholly owned by the Schwab Corp., and is under the control of the Schwab Corp. and
11 defendant Schwab.

12 31. The Index Fund is a series of the Schwab Trust and a member of the Charles
13 Schwab Family of Funds. The Index Fund is managed by the Schwab Trust and advised by the
14 Schwab Advisor.

15 32. The Index Fund issues redeemable securities. Sales of the shares of the Index
16 Fund can only be made by the Schwab Trust to investors pursuant to a Registration Statement
17 and Prospectus filed with the SEC. Investors in the Schwab Fund cannot sell or trade shares
18 among themselves.

19 33. Each investor in the Fund has an individual, indivisible interest in the assets of
20 the Fund based on the ratio of its shares to the total number of shares outstanding. Investors in
21 the Fund can buy or sell shares on a daily basis. The value of the Fund’s shares is computed
22 daily by taking the assessed market value of all portfolio securities, adding the assessed value
23 of other assets and liabilities, and dividing the result by the number of shares outstanding. The
24 Index Fund reports its portfolio holdings to investors on a semi-annual basis in reports issued as
25 of August and February. The Index Fund also reports its portfolio holdings as of May and
26 November in Form N-Q filings with the SEC, which are not mailed to investors. The Fund
27 does not report the dates or prices at which it purchases or sells securities.
28

1 34. The Schwab Trust at times refers to itself and its affiliated companies as
2 “Schwab” and to the Index Fund and other Schwab mutual funds under the tradename “the
3 SchwabFunds,” or as members of the Schwab “Family of Funds” or the “Schwab mutual fund
4 complex.”

5 **CLASS ACTION ALLEGATIONS**

6 35. Plaintiff brings this action as a class action pursuant to Federal Rules of Civil
7 Procedure 23(a) and (b)(3), individually and on behalf of a class consisting of all person or
8 entities who owned shares of the Fund at any time from August 31, 2007 through February 27,
9 2009, and suffered damages as a result thereof (the “Class”). Excluded from the Class are the
10 defendants herein, any subsidiaries or affiliates of the defendants in which defendants or its
11 affiliates have a controlling ownership interest, officers and directors of any of the defendants,
12 heirs, successors and assigns of any of the defendants or their officers and directors, and any
13 entity in which any defendant has a controlling ownership interest.

14 36. August 31, 2007 is the last date of the fiscal year prior to the Fund’s
15 performance first deviating from the Lehman Index. February 27, 2009 is the approximate date
16 by which the Fund reverted back to its required fundamental investment policy to seek to track
17 the Lehman Index through the use of an indexing strategy.

18 37. The members of the Class are so numerous that joinder of all members is
19 impracticable. While the exact number of members of the Class is unknown to Plaintiff at this
20 time and can only be ascertained through appropriate discovery, the Fund had over \$1.5 billion
21 in assets as of August 31, 2007, and approximately 150 million shares outstanding. Plaintiff
22 thereby concludes that there are thousands of members located throughout the United States in
23 the proposed Class. Record owners and other members of the Class may be identified from
24 records maintained by defendants or other affiliated Schwab entities and may be notified of the
25 pendency of this action by mail.

26 38. Plaintiff’s claims are typical of the claims of the members of the Class as all
27 members of the Class are similarly affected by defendants’ wrongful conduct in violation of
28 state law that is complained of herein.

1 39. Northstar has standing to pursue this claim for money damages as assignee of
 2 Holz's claim and in its own right because it suffered direct financial injury as a result of the
 3 Fund's deviation from its stated fundamental investment objectives and policies (and other
 4 claims alleged herein). Northstar's financial injury and entitlement to recovery are derivative
 5 of the Class' claims. Northstar cannot prove its own financial injury and entitlement to
 6 recovery without first proving the Class' financial injury and entitlement to recovery.

7 40. Plaintiff will fairly and adequately protect the interests of the members of the
 8 Class and has retained counsel competent and experienced in class litigation.

9 41. Common questions of law and fact exist as to all members of the Class and
 10 predominate over any questions solely affecting individual members of the Class. Among the
 11 questions of law and fact common to the Class are:

- 12 (a) Whether the Schwab Trust or the Schwab Advisor caused the Index Fund to
 13 deviate from an investment objective or policy that could only be changed by a
 14 shareholder vote;
- 15 (b) Whether the Schwab Trust or the Schwab Investment Advisor were obligated to
 16 cause the Fund to track the Lehman Brothers U.S. Aggregate Bond Index using
 17 an indexing strategy;
- 18 (c) Whether the Index Fund's investments tracked the Lehman Brothers U.S.
 19 Aggregate Bond Index using an indexing strategy;
- 20 (d) Whether the Schwab Trust or Investment Advisor concentrated investments in
 21 the Fund in excess of 25% of its total assets in any one industry;
- 22 (e) Whether non-agency mortgage-backed securities comprise one or more than one
 23 "industry;"
- 24 (f) Whether agency and non-agency mortgage-backed securities comprise one or
 25 more than one "industry;"
- 26 (g) Whether members of the Class are third party beneficiaries of the investment
 27 advisory contract between the Schwab Trust and the Schwab Advisor;
- 28

1 (h) Whether the Schwab Trust or the Schwab Advisor owed members of the Class
2 fiduciary duties;

3 (i) Whether the Schwab Trust or the Schwab Advisor violated fiduciary duties to
4 Class members; and

5 (j) Whether the members of the Class have sustained damages, and, if so, what is
6 the proper measure thereof.

7 42. A class action is superior to all other available methods for the fair and efficient
8 adjudication of this controversy since joinder of all members is impracticable. As the damages
9 suffered by any individual Class member may be relatively small, the expense and burden of
10 individual litigation make it impossible for members of the Class to redress individually the
11 wrongs done to them. There will be no difficulty in managing this action as a class action.

12 **SUBSTANTIVE ALLEGATIONS**
13 **Background and History Prior to the 1997 Shareholder Vote**

14 43. The Schwab Total Bond Market Fund was initiated by the Schwab Trust on
15 March 5, 1993 under a predecessor name – the Schwab Long-Term Government Bond Fund
16 (the “Government Bond Fund”) – as an actively managed bond fund.

17 44. According to the Prospectus for the Government Bond Fund, dated
18 December 30, 1994, as amended June 30, 1995, the “investment objective” of the Government
19 Bond Fund was “to provide a high level of current income consistent with preservation of
20 capital by investing primarily in securities issued or guaranteed by the United States
21 Government, its agencies or instrumentalities and repurchase agreements covering those
22 securities.”

23 45. The June 30, 1995 Prospectus also stated that “[the] Fund’s investment objective
24 ... is fundamental and cannot be changed without approval by holders of a majority of the
25 Fund’s outstanding voting shares.”

26 46. The Prospectus added that “U.S. Government Securities are generally viewed by
27 the Investment Manager as being among the safest of debt securities with respect to the timely
28 payment of principal and interest[.]”

1 47. Schwab was unable to successfully market the Government Bond Fund.

2 48. As of August 31, 1997, after more than four years of operations, the
3 Government Bond Fund only had \$24.8 million in investment assets.

4 **The Formation of the Schwab Total Bond Market Index Fund**

5 49. On July 25, 1997, the Schwab Trust mailed to investors in the Government
6 Bond Fund a Proxy Statement on SEC Form 14A with respect to a shareholder vote “[t]o
7 amend [the] Fund’s fundamental investment objective resulting in changing the Fund from [a]
8 Government bond fund[] to [a] bond index fund[] that would include Government and other
9 fixed income securities.” The Proxy Statement stated that “[t]he changes proposed will give
10 your Fund the opportunity to take advantage of the many benefits offered by an indexing
11 strategy, including a more diversified bond portfolio.”

12 50. The Proxy Statement informed investors that the Board of Trustees of the Fund
13 was proposing to change the Fund’s then-existing investment objective from attempting “to
14 provide a high level of current income consistent with preservation of capital by investing
15 primarily in securities issued or guaranteed by the U.S. Government” to a “proposed
16 investment objective ... to attempt to provide a high level of current income consistent with
17 preservation of capital by seeking to track the investment results of a particular bond index
18 through the use of an indexing strategy.”

19 51. The Proxy Statement added that “[i]f its proposed investment objective is
20 approved, the Total Bond Fund would invest in a portfolio of fixed-income securities that seeks
21 to track the Lehman Brothers Aggregate Bond Index.”

22 52. The Proxy Statement listed, as Proposal 2, “Amending Each Funds’
23 Fundamental Investment Objective,” gave a detailed description of the meaning and
24 significance of the proposed amendments and formed the terms of a contract to provide
25 shareholders with voting rights in that those “fundamental investment objectives” were only
26 changeable by shareholder vote.

27 53. The Lehman Index was described in the Proxy Statement as “a broad market-
28 weighted index which encompasses the following classes of investment grade fixed-income

1 securities: U.S. Treasury and agency securities, corporate bonds, international (dollar-
2 denominated) bonds, agency mortgage-backed securities, and asset-backed securities.”

3 54. The Lehman Index is a proprietary Lehman Brothers index, consisting of over
4 9,000 separate instruments whose exact composition is not generally available to investors.
5 The composition of the Index changes from time-to-time.

6 55. Because the individual bonds in the Lehman Index may be illiquid and cannot
7 be (at least at times) purchased at efficient prices, the Proxy Statement explained that the Index
8 Fund would not necessarily purchase the bonds that were part of the Index but rather would
9 purchase bonds that “closely approximated the Index’s characteristics.”

10 56. The Proxy Statement described the “investment process of indexing” and
11 proposed “indexing strategy” by stating that the Fund “would be unable to hold all of the
12 individual issues which comprise the [Index] because of the large number of securities in the
13 [Index],” and would not necessarily hold securities that were part of the Index, but that the
14 “Fund would hold a portfolio of fixed-income securities that is managed to closely approximate
15 [the] Index’s ‘characteristics’ of coupon rate, duration, sector, quality and optionality (or
16 convexity)”:

17 If the proposed investment objective is approved, the Funds would not be
18 managed according to traditional methods of “active” investment management,
19 which involve the buying and selling of securities based upon economic,
20 financial, and market analyses and investment judgment. Instead, *the Investment*
21 *Manager would utilize a “passive” or “indexing” investment approach, to*
22 *attempt to track the investment performance of each Fund’s Index through*
23 *statistical sampling and other procedures.* The Funds would be unable to hold all
24 of the individual issues which comprise the Indexes because of the large number
25 of securities in the Indexes. *Each Fund would hold a portfolio of fixed-income*
26 *securities that is managed to closely approximate its Index’s “characteristics” of*
27 *coupon rate, duration, sector, quality and optionality (or convexity).* [Emphasis
28 added.]

57. The Proxy Statement assured investors that “[b]efore purchasing or selling a
security, the Investment Manager would analyze each security’s characteristics and determine
whether purchasing or selling the security would help the Fund’s portfolio approximate the
characteristics of the Index”:

Before purchasing or selling a security, the Investment Manager would analyze
each security’s characteristics and determine whether purchasing or selling the
security would help the Fund’s portfolio approximate the characteristics of the

1 Index. As a result, when the Fund's portfolio as a whole is considered, the Fund's
2 performance and risk is expected to be similar to its Index's performance and risk.

3 For example, with respect to the "sector characteristic," if U.S. Treasury and
4 agency securities represent approximately 60% of an Index's interest rate risk,
5 then approximately 60% of the respective Fund's interest rate risk would come
6 from such securities. Similarly, if corporate bonds represent 20% of the Fund's
7 interest rate risk, then they would represent approximately 20% of the Fund's
8 interest rate risk. This technique is expected to enable each Fund to track the
9 coupon income and price movements of its respective Index, while minimizing
10 transaction, custodial and accounting costs.

11 58. The 1997 Proxy Statement represented that the Schwab Investment Manager
12 would seek a 90% correlation between the Fund and the Index:

13 Over the long term, the Investment Manager will seek a correlation between the
14 performance of each Fund, as measured by its net asset value, including the value
15 of its dividend and capital gain distributions, and that of its Index of 0.9 or better.
16 A correlation of 1.0 would indicate perfect correlation, but since each Fund incurs
17 operating expenses, unlike its respective Index, a perfect correlation is unlikely to
18 be achieved. The Investment Manager will monitor the performance of each
19 Fund versus that of its Index on a regular basis. If a tracking error develops, each
20 Fund is rebalanced to help bring it in line with the Index. In the unlikely event
21 that a correlation of 0.9 or better is not achieved, the Board of Trustees of a Fund
22 will consider alternative arrangements.

23 59. The 1997 Proxy Statement described Schwab's rationale for proposing that the
24 Fund be changed to an index fund and the Fund's appeal to passive investors who were seeking
25 "broad bond portfolio diversification" and "a consistent investment style," as follows:

26 Schwab has long been an advocate of indexing as an investment strategy. The
27 Board of Trustees believes the proposed bond index funds will offer customers
28 many benefits through the use of an indexing strategy. These benefits include:
broad bond portfolio diversification, a consistent investment style, and potentially
lower trading costs as a result of lower portfolio turnover and fewer transactions,
over the long term. And, all other things being equal, lower costs can translate
into higher returns.

The objective of an index fund, unlike an actively managed fund, is to closely
track the total return of a benchmark or index for a particular market, or market
sector. Because both proposed Funds plan to invest in a larger number and
broader range of bonds, the Funds should provide investors a more broadly
diversified bond fund investment for their asset allocation plan. The proposed
bond index funds could represent excellent choices for the core component of an
investor's bond fund holdings and could fulfill the bond portion of an asset
allocation plan, whether that plan calls for a longer-term or short-term bond fund.

60. The 1997 Proxy Statement stated that because investors would not be required to
actively monitor and assess the investment selections of the Fund's Investment Advisor (which

1 was charged with the responsibility of following the Index), the bond index fund “should have
2 a broader appeal to a larger number of investors.”

3 In addition, the Board of Trustees believes that the proposed bond index funds
4 should have a broader appeal to a larger number of investors. This would permit
5 the Funds to be marketed more effectively, creating economies of scale if assets
6 grow. These economies could be achieved by spreading the Funds’ fixed costs
7 over a larger asset base, which would potentially lower the Funds’ operating
8 expenses.

9 61. The Proxy Statement sought to assure investors that the change to an indexing
10 strategy would not increase the risk profile of the Fund (which at the time was holding
11 approximately 100% of its assets in securities issued or guaranteed by the U.S. Government)
12 because 80% of the Fund’s assets would still be invested on a current basis in U.S. government
13 or agency bonds, and given the then current composition of the Index, 15% of the portfolio
14 would be invested in investment grade corporate bonds, 4% in international (dollar-
15 denominated bonds), and 1% in asset-backed securities:

16 As shown in the two preceding charts, as of June 30, 1997, both of the proposed
17 index Funds would maintain significant positions in U.S. Treasury and agency,
18 and agency mortgage-backed securities – 85.0% for the Short-Term Bond Market
19 Index Fund and 80.0% for the Total Bond Market Index Fund.

20 The non-U.S. Treasury/agency securities represented in both indices are all
21 investment grade and quite diversified. As a result, both index Funds are
22 expected to maintain relatively low levels of credit risk. However, given that U.S.
23 Treasury and agency securities have the lowest credit risk compared to other types
24 of fixed income securities, the portfolio management team anticipates that the
25 proposed Funds would have a slightly higher level of credit risk than the current
26 Funds.

27 62. The Proxy Statement added that bond securities issued by the U.S. government
28 and its agencies were of the highest credit quality:

29 The risks associated with U.S. Treasury and agency securities, generally
30 considered the least risky form of fixed-income security in terms of credit risks,
31 are detailed in the Funds’ current prospectus.

32

33 Although a higher return is expected from corporate bonds, these securities will
34 generally not be of the same credit quality and risk as U.S. Treasury and agency
35 securities because they are not issued or guaranteed as to principal and interest by
36 the federal government or its agencies or instrumentalities.

63. The July 25, 1997 Proxy Statement also proposed a change (Proposal No. 3) in the Fund's "fundamental investment policies and investment restrictions" regarding concentration of investments.

64. Previously, the Fund's fundamental investment policies and investment restrictions barred investments of "25% or more of the value of its total assets ... in any industry" (excluding investments in U.S. government, agency, or instrumentality securities):

Each Fund may not:

Purchase securities (other than securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities) if, as a result of such purchase, 25% or more of the value of its total assets would be invested in any industry. Securities issued by governments or political subdivisions or authorities of governments are not considered to be securities subject to this industry concentration restriction.

65. The proposed change incorporated the definition of "concentration" under the Investment Company Act of 1940, and gave the Fund discretion to concentrate investments of greater than 25% of total assets in any industry only if necessary to track the Lehman Index:

Each Fund may not concentrate investments in a particular industry or group of industries, or within one state (except with respect to the Total Bond Market Index Fund and the Short Term Bond Market Index Fund, to the extent that the index which each Fund seeks to track is also so concentrated) as concentration is defined under the Investment Company Act of 1940 or the rules or regulations thereunder, as such statute, rules or regulations may be amended from time to time.

66. The rationale for the proposed change, according to the Proxy Statement, was to incorporate the SEC's interpretation of the term "concentration" from the Investment Company Act of 1940 (which at the time was and remains 25%) to give the Fund greater flexibility in the event of future SEC changes in interpretation:

The current self-designated restriction specifically limits a Fund's investments to less than 25% of a Fund's total assets in a particular industry. Under the Proposal, this current self-designated restriction will be eliminated and replaced by a more flexible proposed restriction. The proposed restriction would continue to prevent each Fund from "concentrating" its investments in a single industry or in a state, except if the Index that the Fund tracks is "concentrated" in a particular industry or state. Further, to provide flexibility, the concept of "concentration" in a Fund's proposed restriction is articulated so as to always track the current meaning of "concentration" under the 1940 Act.

At present, "concentration" is interpreted under the 1940 Act in a manner consistent with each Fund's current self-designated restriction (25% or more).

1 However, in order to achieve greater flexibility (if for instance the percentage
2 limitation were to be changed by the SEC), the proposed restriction would
3 eliminate the specific percentage reference and instead define the term
4 “concentration” with respect to the meaning conferred under the 1940 Act.
5 Because the present interpretation of the percentage limit of “concentration”
under the 1940 Act is the same as the current concentration restriction, it is not
expected that there would be any immediate impact on a Fund’s operations as a
result of approving this aspect of the proposed concentration restriction. Any
future change in operations would occur only if the SEC staff changed its
interpretation of what constitutes “concentration.”

6 67. There has been no subsequent change in the SEC’s interpretation of what
7 constitutes “concentration.”

8 68. On September 25, 1997, the Schwab Trust filed a Prospectus Supplement with
9 the SEC reporting that the shareholders of the Schwab Government Fund and shareholders of
10 the Schwab Short/Intermediate Government Bond Fund had approved Proposal Nos. 2 and 3,
11 including the “[a]mendment of each Fund’s Fundamental investment objective resulting in
12 changing each Fund from a Government bond fund to a bond index fund that would include
13 Government and other fixed income securities.”

14 69. The Prospectus Supplement emphasized further that “[a]s a result of the
15 shareholder vote, each Fund’s fundamental investment objective is amended to allow each
16 Fund to pursue an indexing strategy”:

17 As a result of the amendment referenced in Item No. 1 above, as of November 1,
18 1997, the name of the Schwab Short/Intermediate Government Bond Fund will be
19 changed to the Schwab Short-Term Bond Market Index Fund, and the name of the
20 Schwab Long-Term Government Bond Fund will be changed to the Schwab Total
21 Bond Market Index Fund. As a result of the shareholder vote, each Fund’s
22 fundamental investment objective is amended to allow each Fund to pursue an
indexing strategy. The Schwab Short-Term Bond Market Index Fund will seek to
track the Lehman Brothers Short (1-5) Government/Corporate Index and the
Schwab Total Bond Market Index Fund will seek to track the Lehman Brothers
Aggregate Bond Index. Each index is market-weighted and designed to track the
performance of broad segments of the bond market.

23 70. The Proxy Statement imposed detailed contractual obligations on the Schwab
24 Trust and the Schwab Advisor on how the Fund would be managed. The Proxy Statement also
25 created voting rights on behalf of the Fund’s existing and future shareholders in that the
26 investment objectives and fundamental policies could not thereafter be changed without a
27 majority shareholder vote.
28

71. Defendants' contractual obligations to "seek to track" the Index "through the use of an indexing strategy," and investors' voting rights, were fundamental to the Index Fund's shares and appurtenant to each subsequent share issued by the Schwab Trust.

72. The Registration Statements and Prospectuses dated November 1, 1997 and as amended January 15, 1998 for the Total Bond Fund and the Schwab Short-Term Total Bond Market Index Fund, issued shortly after the 1997 shareholder vote, reiterated the Index Fund's fundamental indexing strategy "to track" a bond index "through the use of an indexing strategy" and that the terms of that undertaking could only be modified by shareholder vote:

INVESTMENT OBJECTIVES:

Each Fund's investment objective is to attempt to provide a high level of current income consistent with preservation of capital by seeking to track the investment results of a particular bond index through the use of an indexing strategy.

Each Fund's investment objective is fundamental, which means that it may be changed only by vote of a majority of a Fund's shareholders.

73. That same recitation of the Fund's investment objective was contained in subsequent Prospectuses for the Fund (dated March 17, 1998, November 4, 1998), as well as in Statements of Additional Information incorporated by reference into those and subsequent Prospectuses.

74. A Statement of Additional Information (or "SAI") contains a more comprehensive discussion of material facts than is contained in a Prospectus.

75. In Prospectuses issued by the Schwab Trust with respect to the Fund, including Prospectuses dated November 13, 2003; November 15, 2004; November 15, 2005; November 15, 2006; November 15, 2007; and November 15, 2007, as amended June 13, 2008, defendants prominently reported in large type-face at the front of the Prospectus that the Fund was "designed to offer high current income by tracking the performance of the Lehman Brothers U.S. Aggregate Bond Index" and was "intended for investors seeking to fill the fixed income component of their asset allocation plan":

THE SCHWAB TOTAL BOND MARKET FUND TM is designed to offer high current income by tracking the performance of the Lehman Brothers U.S. Aggregate Bond Index. The fund invests primarily in a diversified portfolio of

investment-grade debt instruments. The fund is intended for investors seeking to fill the fixed income component of their asset allocation plan.

76. These Prospectuses added with respect to the Index Fund's fundamental investment policies that:

The STATEMENT OF ADDITIONAL INFORMATION (SAI) includes a more detailed discussion of investment policies and the risks associated with various investments. The SAI is incorporated by reference into the prospectus.

77. The Statement of Additional Information attached to the November 15, 2003 Prospectus – and all Statements of Additional Information, issued by the Trust with respect to the Fund, including the SAIs dated November 15, 2005 and November 15, 2006 – reaffirmed investors' contractual voting rights and that the Index Fund would continue to track the Index until that investment objective was changed by shareholder vote:

Each fund's investment objective is to attempt to provide a high level of current income consistent with preservation of capital by seeking to track the investment results of a particular bond index through the use of an indexing strategy.

The indexes are the Lehman Brothers Mutual Fund Short (1-5 Year) U.S. Government/Credit Index for the Schwab Short-Term Bond Market Fund (the Short-Term Index), and the Lehman Brothers U.S. Aggregate Bond Index for the Schwab Total Bond Market Fund (the U.S. Aggregate Bond Index).

Each fund's investment objective may be changed by vote of a majority of its outstanding voting shares.

78. Schwab actively marketed the Index Fund to investors, on its website (www.schwab.com) and elsewhere as an index fund. For example, Schwab, in its "On Investing" magazine for "Spring 2006," described as "The Financial Journal of the Charles Schwab Corporation," identified the "Schwab Total Bond Market Fund" as a "Bond Index Fund" and compared its performance to the Dreyfus Bond Market Index Fund.

79. Similarly, Schwab's "Mutual Fund Report Card," available on Schwab's website, as of July 31, 2008, referred to the Fund, and continues to refer to the Fund, as an "Index Fund."

80. The Index Fund's conversion to an indexing strategy was a great success for Schwab, as net assets increased from \$24 million as of August 31, 1997 to approximately \$1.5 billion as of August 31, 2007.

1 81. The Schwab Trust, in the August 31, 1998 Annual Report to shareholders (and
2 repeated in subsequent annual and semi-annual reports to shareholders, including the
3 semiannual report dated February 29, 2000) reiterated the conservative nature of the Index
4 Fund's indexed securities:

5 Schwab's Bond Index Funds seek to track the total returns of broadly diversified
6 bond indices. And because index funds generally result in lower portfolio
7 turnover and fewer transactions—and therefore lower trading costs—you could
8 potentially realize higher returns.

9 In addition to some of the same benefits of equity index funds, including broad
10 diversification, lower expenses, consistent investment style and straightforward
11 choices, bond index funds can also provide the added benefit of high credit-
12 quality investments. Schwab's Bond Index Funds are designed to maintain high
13 credit-quality standards because the indices they seek to track primarily comprise
14 U.S. Treasuries, government agency securities and government agency mortgage-
15 backed securities; the remaining bonds in the indices are investment-grade
16 corporate bonds rated AAA through BBB, the four highest credit ratings.

17 82. The government agency mortgage-backed securities referenced in the Fund's
18 SEC documents (including the June 1997 Proxy) and included in the Lehman Index were
19 issued by the Governmental National Mortgage Association ("Ginnie Mae"), the Federal
20 National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage
21 Corporation ("Freddie Mac"). Ginnie Mae, Fannie Mae, and Freddie Mac are U.S.
22 Government agencies (also known as Government Sponsored Enterprises ("GSEs"))
23 established by Congress to facilitate residential mortgage loans.

24 83. The GSEs purchased and securitized mortgage loans that met established criteria
25 for creditworthiness.

26 84. The government agency mortgage-backed securities referenced in the 1997
27 Proxy as contained in the Index were fixed income pass-through securities, in which all
28 principal and interest on the underlying mortgages is passed through to the mortgage-backed
securities investor.

 85. The type of securities that could be acquired by those agencies are restricted by
their government charters.

 86. Ginnie Mae benefits from an express U.S. Government guarantee of payment on
its securities.

1 87. Both Fannie Mae and Freddie Mac benefit from an implied U.S. Government
2 guarantee of payment on their securities by virtue of their status as U.S. chartered institutions.

3 88. The mortgage-backed securities issued by Ginnie Mae, Fannie Mae and Freddie
4 Mac, and maintained in the Lehman Index, had the highest credit quality among mortgage-
5 backed securities.

6 89. The Statement of Additional Information dated May 6, 2002, reported that the
7 Fund had changed its name to the Schwab Total Bond Market Fund:

8 Prior to May 6, 2002, . . . Schwab Total Bond Market Fund was named Schwab
9 Total Bond Market Index Fund.

10 90. This Statement of Additional Information was not mailed to investors. No
11 explanation was given by given by Schwab Trust or Investment Advisor for the change in
12 name. Upon information and belief, the Schwab Trust was required by the SEC to delete the
13 word “Index” from the Fund name because the Fund’s fundamental investment objective did
14 not require the Fund to own the actual securities that were part of the Index but rather only to
15 own those securities that “closely approximated the Index’s characteristics.”

16 91. The change in Fund name was not approved by Fund shareholders and had no
17 consequence to investors’ contractual voting rights with respect to the Fund’s fundamental
18 investment objectives.

19 92. The May 6, 2002 Statement of Additional Information, incorporated by
20 reference into the May 6, 2002 Prospectus, and each subsequent (and previous) SAI,
21 incorporated by reference into each subsequent (and previous) Prospectus, continued to state
22 that shareholders’ voting rights and the Fund’s investment objective were unchanged and could
23 only be changed by a majority shareholder vote, which had not occurred:

24 Each fund’s investment objective is to attempt to provide a high level of current
25 income consistent with preservation of capital by seeking to track the investment
26 results of a particular bond index through the use of an indexing strategy.

26 * * *

27 Each fund’s investment objective may be changed by vote of a majority of its
28 outstanding voting shares.

1 93. From August 31, 1997 through August 31, 2007, the Fund substantially
 2 performed in a manner that was consistent with the Index, returning an annualized rate of
 3 5.75% compared to 6.04% for the Index -- within the 10% deviation anticipated by the
 4 Investment Manager.

5 94. As stated in the Fund's annual and semi-annual reports, this degree of deviation
 6 between the Fund and the Index occurred "mainly because, unlike the Index, the Fund incurs
 7 operating expenses and trading costs and must keep a small part of its assets in cash for paying
 8 expenses and processing shareholder orders."

9 **The Fund Substantially Deviates From Its Stated Investment Objective**

10 95. The Fund first reported a material performance deviation from the Index in its
 11 Semi-Annual Report for the period ended February 27, 2008, filed with the SEC on May 6,
 12 2008:

13 The Schwab Total Bond Market Fund returned 3.41% underperforming
 14 Lehman Brothers U.S. Aggregate Bond Index, which was up 5.67%. Risk
 15 aversion and forced selling in the fixed income market, combined with persistent
 16 volatility, impacted the fund as investors remained cautious of all non-
 Government securities irrespective of underlying credit quality. Under these
 conditions of extreme volatility, U.S. Treasuries outperformed all other fixed
 income securities.

17 During the period, the financial markets experienced liquidity and
 18 confidence issues as the collapse of the subprime mortgage market and related
 19 credit turmoil cascaded into other sectors. Correspondingly, a reprising of risk
 20 premiums and a flight to quality across all segments of the fixed income market
 21 contributed to downward pricing pressure, with prices for many non-U.S.
 Treasury securities falling regardless of their quality or fundamentals. In order to
 22 maintain liquidity, many investors were forced to sell high quality assets at
 depressed prices. This selling pressure occurred at the same time demand for
 non-U.S. Treasury securities was weakest, and as a result prices were driven
 down even further.

23 96. Investors in the Fund, however, could not anticipate from this Report that the
 24 Fund would continue to deviate from the Index. Among other things, the Prospectus dated
 25 September 15, 2007 had stated that "the Fund primarily invests in a diversified portfolio of debt
 26 investments that is designed to track the performance of the Lehman Brothers U.S. Aggregate
 27 Bond Index" and that "[y]our investment follows the bond market, as measured by the index.
 28 The fund is designed to follow the performance of the index during upturns as well as

1 downturns.” The November 15, 2007 Statement of Additional Information also reiterated that
2 the Fund’s “investment objective is to attempt to provide a high level of current income
3 consistent with preservation of capital by seeking to track the investments results of [the Index]
4 through the use of an indexing strategy.”

5 97. In fact, the explanation given for the underperformance of the Index Fund
6 compared to the Index, was the forced selling of securities into a weak bond market, rather than
7 the violation of shareholders’ voting rights and the deviation of the securities in the Fund from
8 the Index.

9 98. The Schwab Trust had informed investors in the 1997 Proxy Statement that
10 some volatility in the Fund against the Index may not be totally avoidable, and that “if a
11 tracking error develops, each Fund is rebalanced to help bring it in line with the Index.”

12 99. The Fund had also consistently tracked the Index for the prior decade since
13 inception.

14 100. From 2002 until June 2008, Kimon Daifotis acted as the senior vice president
15 and chief investment officer of the Investment Advisor, responsible for the overall management
16 of the Fund. On June 13, 2008, Schwab Investments filed a Supplement to the Fund’s
17 Prospectus dated November 15, 2007, stating that Jeffrey Mortimer was then responsible for
18 the overall management of the Fund. No explanation was given by defendants, in the
19 Prospectus or elsewhere, for replacing Daifotis as Fund Manager. Investors were not informed
20 that Daifotis had engaged in an investment strategy that was inconsistent with shareholders’
21 voting rights and the Fund’s stated investment objectives and policies.

22 101. The Fund’s underperformance against the Index continued subsequent to
23 February 27, 2008 as the Schwab Advisor sought to liquidate the non-agency CMOs into a
24 weak bond market for high risk securities. From August 31, 2007 through February 27, 2009,
25 the Fund experienced a negative total return of 4.80% compared to a positive 7.85% total return
26 for the Index – a total underperformance of 12.64% in absolute terms (including interest
27 payments).

1 102. The Fund's shares had closed on August 31, 2007 at \$9.72 a share.
2 Accordingly, the 12.63% differential in performance between the Index and the Fund is
3 equivalent to damages per share of approximately \$1.23.

4 103. The Fund's deviation in performance from the Index was caused by the Fund's
5 investment of 27.3% of assets as of February 27, 2008 in non-agency collateralized mortgage
6 obligations ("CMOs").

7 104. The CMOs in the Fund's portfolio were not issued by government agencies.
8 Rather they were issued by financial institutions through subsidiaries and backed by residential
9 loans that did not conform to the agencies' high loan underwriting requirements.

10 105. Moreover, non-agency CMOs purchased by the Investment Manager for the
11 Fund represented tranches of mortgage-backed securities, such as principal only or interest only
12 payments, and were significantly more risky than the agency-issued mortgage-backed securities
13 that were part of the Index. Included in the Fund's portfolio were CMOs sponsored by such
14 subprime lenders as Citigroup, Merrill Lynch, Countrywide, Bear Stearns, IndyBank, Lehman,
15 and Washington Mutual.

16 106. This concentration of investments in mortgage backed securities was also in
17 violation of the Fund's stated investment objectives that the Fund's assets not be concentrated
18 more than 25% in any one industry (except as required by the Index).

19 107. The composition of the Lehman Index is proprietary and not publicly available.
20 However, subsequent analyses of other bond index funds that represent that they track the
21 Lehman Bros. Aggregate Bond Index indicates that as of February 27, 2008, the Lehman
22 Government Index had a 0% weighting in non-agency mortgage-backed securities, and a 37%
23 weighting in agency mortgage-backed securities.

24 108. Moreover, according to the February 28, 2008 Semi-Annual Report, the Fund
25 was invested 45.4% in agency and non-agency mortgage backed securities.

26 109. The Fund's investment in non-agency CMOs violated shareholders' voting
27 rights and the Fund's fundamental investment objective to "seek to track" the Index "through
28

1 the use of an indexing strategy.” The non-agency CMOs did not “closely approximate” the
2 “characteristics” of the securities in the Lehman Index.

3 110. By November 30, 2008, the Index Fund had lessened its exposure to non-agency
4 CMOs to 3.4% of total assets. The liquidation of the non-agency CMO portfolio into an
5 illiquid bond market for risky securities coincided with the further deviation in performance of
6 the Fund.

7 111. Defendants have taken the position, as stated in the Statement of Additional
8 Information dated November 15, 2007, as amended June 13, 2008 , to justify the Fund’s over-
9 concentration in non-agency mortgage-based securities and CMOs, that non-agency mortgage-
10 backed securities “are not part of any industry for purposes of a fund’s concentration policy”:

11 Based on the characteristics of mortgage-backed securities, the funds have
12 determined that mortgage-backed securities issued by private lenders and not
13 guaranteed by U.S. government agencies or instrumentalities are not part of any
14 industry for purposes of a fund’s concentration policy. This means that a fund
15 may invest more than 25% of its total assets in privately-issued mortgaged-backed
securities, which may cause the fund to be more sensitive to adverse economic,
business or political developments that affect privately-issued mortgage-backed
securities.

16 112. Defendants’ determination that non-agency CMOs were not part of an
17 “industry” was unreasonable, in violation of shareholders’ voting rights, and inconsistent with
18 the Fund’s stated investment policy that was only changeable by shareholder vote. Defendants
19 recognized, as stated in the November 15, 2007 Statement of Additional Information, as
20 amended June 13, 2008 (quoted immediately above), that the non-agency investments “may
21 cause the fund to be more sensitive to adverse economic, business or political developments
22 that affect privately-issued mortgage-backed securities” and accordingly should be classified as
23 within one industry.

24 113. Agency and non-agency CMOs are routinely considered to be part of an
25 “industry” because they derive their value from real estate holdings.

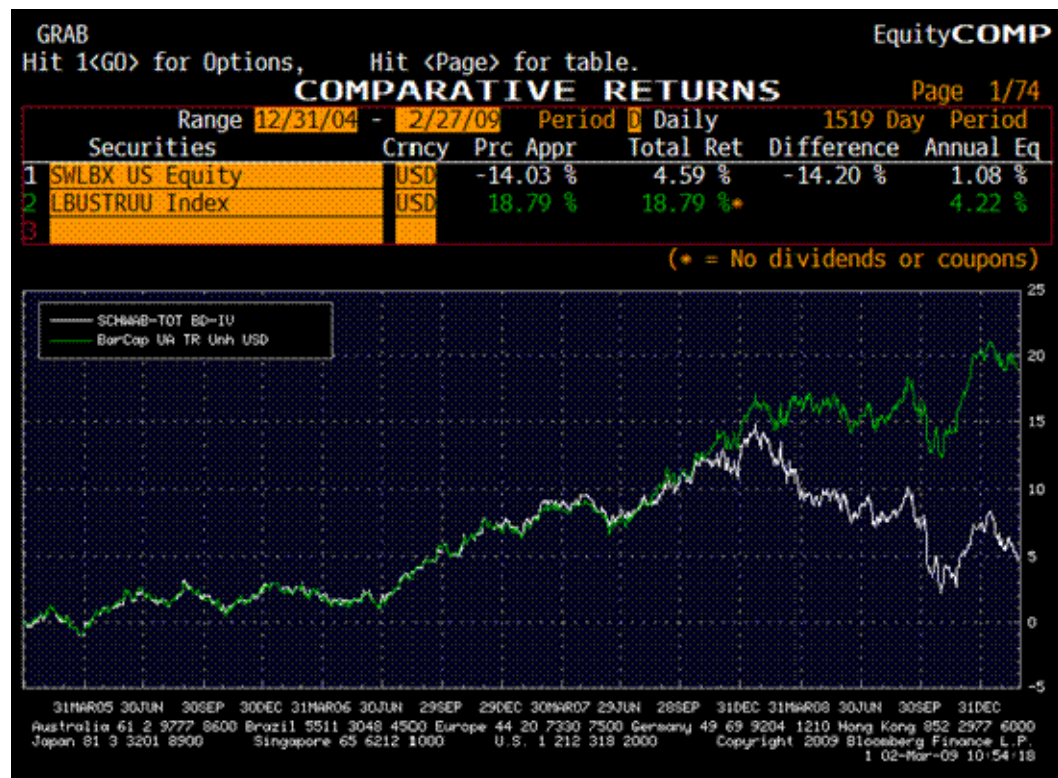
26 114. Consistent with the 1997 Proxy Statement, defendants were not allowed to
27 defeat shareholder’s voting rights by creating unreasonable classifications of an “industry.”
28

115. The Fund's investment in CMOs were made at a time when there was increased concern with the quality of mortgage lending.

116. For example, on June 28, 2007, the Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, and National Credit Union Administration, issued a joint Statement on Subprime Mortgage Lending "to address subprime mortgage products and lending practices."

117. The Fund's investment in non-agency CMOs at this time, in light of all circumstances, was speculative, irresponsible and a gross deviation from the Fund's fundamental investment policies and a breach of the defendants' fiduciary duties.

118. The attached chart, prepared on a Bloomberg terminal, comparing the Schwab Fund's change in total return to the Lehman Index's change in total return over the period December 31, 2004 through February 27, 2009, demonstrates how closely correlated the Schwab Bond Fund was to the Index until approximately August 31, 2007 and how dramatically the Bond Fund deviated thereafter from the Index through February 27, 2009.



119. The magnitude of under performance between the Fund and the Index was not the result of unforeseen economic circumstances, but rather the gross deviation by the Schwab Advisor from the Fund's stated investment objective, by investing 45.4% of the Fund's total assets in mortgage-backed-securities and 27.3% of the Fund's total assets in non-agency CMOs.

FIRST CAUSE OF ACTION

**ON BEHALF OF THE CLASS FOR BREACH OF FIDUCIARY DUTY
(ON BEHALF OF THE CLASS AGAINST ALL DEFENDANTS)**

120. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs as if fully set forth herein. This Count is asserted against the Schwab Trust (Schwab Investments), the Schwab Advisor (Charles Schwab Investment Management, Inc.), and the Schwab Trustees. All defendants owed fiduciary duties to Class members.

121. This Count is asserted under California law. The relationship of Class members to the defendants is not as a shareholder to a corporation, but rather is akin to the relationship between an investor and its financial advisor. The Trust is a legal fiction in that it has no employees, assets, or management capabilities. Rather, it was created by and is subject to the control of the Schwab Corp. and defendant Schwab. The Schwab Trust does not act as an independent entity but rather as part of the Schwab affiliated companies. Investors' primary investment relationship is with the Schwab Advisor, which has the actual responsibility for managing the Fund's assets. Because the defendants and the controlling entities are headquartered in San Francisco, California and the principal activities of the defendants with respect to this Count took place in California, California has the principal interest in applying its law to this claim. Moreover, the Trust's Investment Advisory Agreement with the Schwab Advisor provides that California law shall apply. This Count is viable under Massachusetts law, as well.

122. Schwab Investments is a registered investment company and the sponsor of the Fund. Schwab Investments, through its Trustees and affiliates, was responsible for the oversight of the Fund's investments, the oversight of the activities of the Investment Advisor,

1 and the accuracy of Schwab Investments' SEC filings. The Schwab Trustees are responsible
2 for discharging the obligations of the Trust. Schwab Investments and the Schwab Trustees
3 were also responsible for preserving shareholders' voting rights and the Fund's compliance
4 with its stated investment objectives. Schwab Investments and the Schwab Trustees had
5 discretion to operate the Fund, subject to shareholders' voting rights and the Fund's stated
6 fundamental investment policies, and Class members were reliant on Schwab Investments and
7 the Schwab Trustees for the operations of the Fund.

8 123. The Trustees are liable to investors for gross negligence and reckless disregard
9 of their obligations to protect shareholder interests and voting rights and to ensure that the
10 Fund's assets were invested consistent with the Fund's stated fundamental investment
11 objectives.

12 124. Schwab Investments and its Board of Trustees' fiduciary obligations to the Class
13 were summarized in the Schwab Investments' Definitive Proxy Statement for the Fund, filed
14 with the SEC on March 24, 2000, as follows:

15 The Board of Trustees is responsible for protecting the interests of the funds'
16 shareholders. The Board meets regularly to review the funds' activities,
contractual arrangements and performance.

17 125. Indeed, Charles Schwab, personally, in his letter to shareholders appended to the
18 August 31, 2007 Annual Report filed by Schwab Investments with the SEC, on behalf of all
19 Schwab-related entities, thanked the Fund's shareholders for "entrusting us with their assets."

20 126. Schwab Investments further acknowledged in its August 31, 2007 Annual
21 Report to Shareholders that "as part of their fiduciary duties with respect to fund fees, fund
22 boards are required to evaluate the material factors applicable to their decision to approve an
23 investment advisory agreement."

24 127. The Schwab Advisor had control of the property of the investors and a disparity
25 of sophistication and access to data about the composition of the Index and the Fund's
26 securities holdings.

1 128. The Fund’s prospectus explains that the Investment Advisor provided advisory
2 services in that it utilized discretion and control to “oversee[] the asset management and
3 administration of the funds.”

4 129. All defendants repeatedly assumed fiduciary obligations in SEC filings
5 disseminated to shareholders and repeatedly thanked investors for placing their “trust” in
6 Schwab. *See, e.g.*, Semiannual Report dated February 28, 2007 to Shareholders (Charles
7 Schwab: “Thank you for placing your trust in SchwabFunds.”); Annual Report to
8 Shareholders dated August 31, 1998 and Semiannual Report to Shareholders dated February
9 28, 1999 (Charles Schwab: “We continue to do everything we can to warrant the trust you
10 have placed in us.”); Annual Report dated August 31, 1999 (“We continue to do our best to
11 warrant the trust you have placed in us.”); Semiannual Report dated February 28, 2002 (Charles
12 Schwab: “Thank you for the trust that you have placed in SchwabFunds”); Annual Report,
13 dated August 31, 2002 (Charles Schwab: “We appreciate your trust and will continue to work
14 hard to earn it.”); Semiannual Report dated February 28, 2003 (Charles Schwab: “Your
15 continued trust and support mean a great deal to us, and it’s our goal to respond to them by
16 doing everything we can to help you meet your financial goals”; and Randall W. Merk
17 (President and CEO of the Schwab Advisor): “Times of market volatility and uncertainty about
18 world events seem to demand a heightened level of diligence on the part of investment
19 professionals. At SchwabFunds we are keenly aware to this, and we’re working hard to uphold
20 the best interests of our shareholders”); Semiannual Report dated February 27, 2004
21 (Randall W. Merk: “[T]rust of our shareholders is very important to us, and we invest with
22 your outcomes in mind. Thank you for investing with us, and once more I want to remind you
23 that we operate our business with the highest ethical standards and an unwavering commitment
24 to you.”); Annual Report dated August 31, 2004 (Charles Schwab: “[W]e recognize that your
25 investment reflects the trust you have placed in those of us responsible for managing your
26 wealth, and it is a responsibility that we assume with the utmost integrity.”; and
27 Evelyn Dilsaver (President and CEO of the Schwab Advisor): “[“Y]our trust is very important
28 to us and I will do all I can to earn and maintain that trust.”).

1 130. Undeniably, the Schwab Trust, the Schwab Trustees, and the Schwab Advisor
2 owed Class members a fiduciary duty to manage the Fund's assets with the care and prudence
3 of a professional in like circumstances and to adhere to the Fund's investment objectives and
4 policies. Given the disparity of access to information and expertise in investment matters,
5 Class members relied on the Schwab Trust's, the Schwab Trustees', and the Schwab Advisors'
6 diligence and good faith.

7 131. Schwab Investments repeatedly stated that the Fund was "intended for investors
8 seeking to fill the fixed income component of their asset allocation plan." The Investment
9 Advisor was aware of that statement and recognized that Class members were relying on its
10 management of the Fund.

11 132. The Schwab Trust, the Schwab Trustees, and the Schwab Advisor had actual
12 knowledge that the funds safeguarded to Schwab for investment were of great significance to
13 investors and would be used for such once-in-a-lifetime events as to purchase a first home, pay
14 for college, or retirement.

15 133. Defendants acknowledge on the "Charles Schwab" website that Schwab
16 Investments, by creating the Fund and recommending that the Fund be used in an investment
17 plan "to fill the fixed income component of [investors'] asset allocation plan" were acting in a
18 fiduciary capacity: "Professional investors consider creating an investment plan vital for
19 performing their fiduciary duty to clients." See "Investing Principle 1: A Blueprint for
20 Success," by Mark W. Riepe, CFA, Senior Vice President, Schwab Center for Financial
21 Research, March 10, 2008.

22 134. Defendants breached their fiduciary duties to plaintiff and the members of the
23 Class by the acts and omissions set forth above in violation of the shareholders' voting rights
24 and the Fund's stated investment objectives, including the failure to require a majority
25 shareholder vote prior to deviating from the Fund's stated fundamental investment objectives.

26 135. The Trustees, by failing to review the Fund's portfolio to ensure that it complied
27 with the Fund's stated fundamental investment objectives that were only changeable by
28 shareholder vote, acted with gross negligence and with reckless disregard of their obligations.

136. By virtue of the wrongful conduct of defendants, plaintiff and the members of the Class sustained money damages in connection with their ownership of shares in the Fund.

SECOND CAUSE OF ACTION

FOR BREACH OF CONTRACT (ON BEHALF OF THE CLASS AGAINST SCHWAB INVESTMENTS)

137. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs as if fully set forth herein. This Count is asserted on behalf of members of the Class for breach of contract.

138. Proposal Number 2 of the 1997 Proxy Statement formed the terms of a contract between the Schwab Trust and investors in the Fund that if investors voted in favor of changing the Fund's fundamental investment objective to seek "to track the investment results of the [Index] through use of an indexing strategy" that Schwab Investments would cause the Fund to conform to that objective. Investors in the Fund accepted that offer by voting in favor of the change in investment objective. See Proxy Statement at 3 ("[T]he Total Bond Market Index Fund ... would seek to track the Lehman Brothers Aggregate Bond Index.").

139. The 1997 Proxy Statement also created voting rights for the Index Fund's investors.

140. In its 1997 Proxy Statement, Schwab Investments set forth in detail the meaning of the term "indexing strategy" that could only be changed by shareholder vote. Thus, for example, on page 22 of the Proxy Statement Schwab Investments promised investors that "[b]efore purchasing or selling a security, the Investment Manager would analyze each security's characteristics and determine whether purchasing or selling the security would help the Fund's portfolio approximate the characteristics of the Index."

141. Proposal Number 3 of the 1997 Proxy Statement also formed the terms of a contract whereby Schwab Investments covenanted that, subject to shareholder vote, the Fund "may not" "[p]urchase securities (other than securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities) if, as a result of such purchase, 25% or more of the value of its assets would be invested in any industry."

1 142. The Fund's shareholders accepted the terms of that contract by voting in favor
2 of those fundamental investment policies.

3 143. Subsequent to the 1997 proxy vote, Schwab Investments continued to offer
4 shares in the Fund pursuant to the terms of a contract that Schwab Investments would preserve
5 shareholders' voting rights and cause the Fund to continue to adhere to its fundamental
6 investment objectives and policies contained in the 1997 Proxy Statement and reiterated in
7 Prospectuses and in Statements of Additional Information (as quoted above). Investors
8 accepted the terms of that contract by purchasing shares in the Fund.

9 144. The terms of that contract are contained in the 1997 Proxy Statement, which
10 established the contractual relationship between Schwab Investments and Class members, and
11 were reiterated in Schwab Investments' subsequent SEC filings, including the January 15, 1998
12 Prospectus, and in each subsequent Prospectus and Statement of Additional Information
13 incorporated by reference into and made a part of the Prospectus.

14 145. The aforesaid provision constituted contractual terms, where existing investors
15 retained shares and new investors purchased shares in consideration of the contractual
16 obligations not to change fundamental investment objectives without a shareholder vote.

17 146. Plaintiff and the Class also relied on federal law for the terms of that contract.
18 Section 8 of the Investment Company Act directs an investment company to recite in its
19 Registration Statement "all investment policies of the registrant . . . , which are changeable only
20 if authorized by shareholder vote," as well as all policies that "the registrant deems matters of
21 fundamental policy." 15 U.S.C. § 80a-8(b) (2) & (3). Section 13 prohibits a registered
22 investment company from deviating from any such policies "unless authorized by the vote of a
23 majority of its outstanding voting securities." 15 U.S.C. § 80a 13.

24 147. Schwab Investments violated the terms of the contract with the Fund's
25 shareholders as set forth in the 1997 Proxy Statement and subsequent prospectuses and SAIs, as
26 more fully described above, by directing the purchases or allowing the Schwab Advisor to
27 direct the purchases of securities that deviated from the composition of the Lehman Brothers
28

1 U.S. Aggregate Bond Index and caused the Fund to concentrate more than 25% of its net assets
2 in mortgage backed securities, including CMOs, without a shareholder vote.

3 148. By virtue of the wrongful conduct of defendants, plaintiff and the members of
4 the Class sustained injury to their voting rights and money damages in connection with their
5 ownership of shares in the Fund.

6 **THIRD CAUSE OF ACTION**

7 **FOR BREACH OF COVENANT OF GOOD FAITH AND FAIR DEALING**
8 **(ON BEHALF OF THE CLASS AGAINST THE TRUST AND THE INVESTMENT**
9 **ADVISOR DEFENDANTS)**

10 149. Plaintiff repeats and realleges the allegations contained in the foregoing
11 paragraphs as if fully set forth herein. This Count is asserted on behalf of members of the Class
12 for breach of the covenant of good faith and fair dealing.

13 150. Defendants have a common law duty of good faith and fair dealing with respect
14 to investors in the Fund.

15 151. Defendants, in violation of the covenant of good faith and fair dealing, engaged
16 in speculation with the Fund's assets by investing more than 25% of the Fund's total assets in
17 CMO securities that were not contained in the Lehman Index, and engaged in such speculation
18 without a shareholder vote.

19 152. By virtue of the wrongful conduct of defendants, plaintiff and the members of
20 the Class sustained money damages in connection with their ownership of shares in the Fund.
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FOURTH CAUSE OF ACTION

**THIRD PARTY BENEFICIARY OF THE INVESTMENT ADVISORY AGREEMENT
(ON BEHALF OF THE CLASS AGAINST THE INVESTMENT ADVISOR)**

153. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs as if fully set forth herein.

154. The Investment Advisor managed the investments of the Fund pursuant to an Investment Advisory Agreement between the Investment Advisor and Schwab Investments.

155. The Investment Advisory Agreement required the Investment Advisor, among other things, to manage the Fund consistent with the Fund's fundamental investment objectives and policies.

156. The Investment Advisory Agreement between the Schwab Investment Manager and the Schwab Trust unambiguously charged the Investment Advisor with performing "all aspects of the operations of the Schwab Funds," which included, but were not limited to: determining "what securities and other investments will be purchased, retained or sold" by the Fund; furnishing statistical and research data; preparing the Trust's Annual and Semi-Annual Reports to shareholders and amendments to its Registration Statements; preparing and filing Notices with the SEC; keeping and maintaining the financial accounts and records of the Fund; "generally assist[ing] in all aspects of the operations of the" Fund; and complying "with all applicable Rules and Regulations of the SEC." The Advisory Agreement also requires the Investment Advisor to comply with the provisions of the Investment Company Act of 1940 in buying or selling any portfolio securities.

157. Thus, the Advisory Agreement conferred broad obligations upon the Investment Advisor with respect to the overall management of the Fund – the most fundamental of which would include management of the Fund in accordance with the Fund's fundamental investment objectives and policies. It would make little, if any, sense, if the Investment Advisor was free to deviate from the Fund's fundamental investment objectives during its management of the Fund.

1 158. The Trust appended a copy of the Investment Advisory Agreement to an
2 amendment to the Trust's Registration Statement dated December 29, 1997 precisely to inform
3 class members of its terms.

4 159. The Investment Advisory Agreement provided that it "shall be governed by the
5 laws of the State of California."

6 160. Defendant Merk routinely wrote letters to the Fund's shareholders contained in
7 the Fund's annual and semiannual reports and addressed the Fund's shareholders as "Dear
8 Shareholders."

9 161. In a letter to shareholders in the Schwab Trust's August 31, 2005 Annual Report
10 to Shareholders, defendant Charles Schwab emphasized the direct obligations and commitment
11 of the Schwab Investment Managers to the shareholders of the Schwab mutual funds:

12 Schwab Funds is managed by Charles Schwab Investment Management, Inc.,
13 one of the largest mutual fund managers in the U.S. Our portfolio managers
14 share a passion for market analysis and use some of the most sophisticated
15 financial models in the country. I am proud of their depth of experience, which
16 reflects an average tenure of more than 15 years in the investment industry.
17 *Furthermore, I am impressed with the commitment that our managers bring to
18 the stewardship of the funds, for you, their shareholders.* [Emphasis added.]

19 162. The shareholders of the Fund were known and intended third party beneficiaries
20 of the Investment Advisory Agreement.

21 163. Inasmuch as Schwab Investments issued and redeemed shares of the Fund on a
22 daily basis at its reported NAV, if the Investment Advisor managed the Fund in a manner that
23 was inconsistent with the Fund's fundamental investment objectives, the Fund's shareholders
24 would be subject to direct financial injury.

25 164. The Investment Advisor breached the terms of its Investment Advisory
26 Agreement with Schwab Investments by violating shareholders' voting rights and failing to
27 manage the Fund's assets in a manner consistent with the Fund's fundamental investment
28 objectives by investing in securities, including non-agency CMOs, which deviated from the
securities contained in the Index, and by concentrating greater than 25% of the Fund's assets in
non-agency CMOs.

1 165. Class members suffered actual and direct financial damages and injury to their
2 voting rights, as a result of the Investment Advisor's failure to manage the Fund's assets in a
3 manner consistent with the Fund's fundamental investment objectives and policies.

4 WHEREFORE, plaintiff prays for relief and judgment, as follows:

5 A. Determining that this action is a proper class action and certifying plaintiff
6 Northstar as a representative of the Class under Rule 23 of the Federal Rules of Civil
7 Procedure;

8 B. Appointing Wolf Popper LLP and Greenbaum Rowe Smith & Davis LLP as
9 Class Counsel;

10 C. Awarding compensatory damages in favor of plaintiff and the members of the
11 Class against all defendants, jointly and severally, for all damages sustained as a result of
12 defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

13 D. Disgorging from defendants for the benefit of the Class any management or
14 other fees forfeited by Defendants' deviation from the Fund's fundamental investment
15 objectives;

16 E. Directing the defendants to preserve shareholders' voting rights and comply
17 with the Fund's fundamental investment objectives;

18 F Awarding plaintiff and the Class their reasonable costs and expenses incurred in
19 this action, including counsel fees and expert fees;

20 G. Awarding recessionary damages; and

21 H. Such equitable, injunctive or other relief as deemed appropriate by the Court.

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JURY DEMAND

Plaintiff hereby demands a trial by Jury.

Dated: September 28, 2010

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